

Message Text

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ACTION EUR-08

INFO OCT-01 SS-14 ISO-00 NSC-05 NSCE-00 EB-03 TRSE-00

CIAE-00 SP-02 OMB-01 INR-05 PRS-01 /040 W

----- 097217

R 111808Z MAR 76

FM AMEMBASSY ROME

TO SECSTATE WASHDC 6306

C O N F I D E N T I A L SECTION 1 OF 2 ROME 4037

LIMDIS

PASS TREASURY AND FRB

E.O. 11652: GDS

TAGS: OVIP, EFIN, IT

SUBJECT: RESULTS OF SECRETARY SIMON VISIT TO ROME

SUMMARY. SECRETARY OF THE TREASURY SIMON VISITED ROME MARCH 7-10 TO DISCUSS WITH ITALIAN LEADERS ITALY'S CURRENT POLITICAL/ECONOMIC SITUATION AND PROSPECTS. HE SAW PRIME MINISTER MORO, TREASURY MINISTER COLOMBO, BOI GOVERNOR BAFFI, AND OTHER CABINET MEMBERS AND MEMBERS OF PARLIAMENT, HEAD OF CONFINDUSTRIA AGNELLI, AND A GROUP OF YOUNG LABOR AND POLITICAL LEADERS. HE HELD BOTH LIMITED AND OPEN PRESS CONFERENCES. THERE WAS GENERAL AGREEMENT BETWEEN US DELEGATION AND ITALIAN LEADERS CONCERNING REMEDIES NEEDED TO CORRECT ITALY'S BASIC ECONOMIC PROBLEMS. SECRETARY SIMON ESPECIALLY STRESSED PROBLEMS OF INFLATION, BUDGET DEFICITS AND LABOR COSTS WHICH HAVE FED INFLATION. ITALIAN LEADERS TENDED TO EMPHASIZE POLITICAL DIFFICULTIES OF TAKING UNPOPULAR POLICY DECISIONS AND NEED FOR INTERIM FINANCING TO BRIDGE THE GAP BETWEEN INTRODUCTION OF CORRECT POLICIES AND TIME WHEN THEY WOULD BEAR ECONOMIC AND POLITICAL FRUIT. SECRETARY SIMON ASSURED ITALIAN LEADERS AND ITALIAN PUBLIC THAT US WOULD NOT ABANDON ITALY IN ITS TIME OF NEED. END SUMMARY.

1. INTRODUCTION. SECRETARY OF TREASURY WILLIAM SIMON, AC-
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COMPANIED BY ASSISTANT TO THE PRESIDENT FOR ECONOMIC AFFAIRS

WILLIAM SEIDMAN AND UNDERSECRETARY OF THE TREASURY FOR MONETARY AFFAIRS EDWIN YEO, MET WITH NUMBER OF ITALIAN OFFICIALS DURING VISIT TO ROME ON MARCH 7-10. ON MARCH 8 ALL THREE MET WITH GOVERNOR PAOLO BAFFI AND DIRECTOR GENERAL RINALDO OSSOLA OF BANK OF ITALY AND HAD WORKING LUNCH AND FORMAL MEETING WITH MINISTRY OF TREASURY EMILIO COLOMBO, DIRECTOR GENERAL OF THE TREASURY FERDINANDO VENTRIGLIA, TREASURY DIRECTOR GENERAL SILVANO PALUMBO AND DR. OSSOLA. ON MARCH 9 SECRETARY SIMON CALLED ON PRIME MINISTER ALDO MORO AND PARTICIPATED IN DCM-HOSTED LUNCH WITH YOUNG POLITICAL AND LABOR LEADERS. AMBASSADOR VOLPE PARTICIPATED IN ALL THESE MEETINGS AND IN A RESTRICTED MEETING BETWEEN MINISTER COLOMBO AND SECRETARY SIMON ON MARCH 8. ON MARCH 10 THE SECRETARY GAVE AN EXCLUSIVE INTERVIEW TO ALFREDO RECANATESI, JOURNALIST WITH MILAN'S FINANCIAL DAILY IL SOLE/24 ORE, FOLLOWED BY AN INFORMAL SESSION WITH US JOURNALISTS IN ROME AND AN OPEN PRESS CONFERENCE. AMBASSADOR VOLPE HOSTED DINNERS ON MARCH 8 FOR FOREIGN MINISTER AND MINISTERS OF TREASURY, FINANCE AND BUDGET AND ON MARCH 9 FOR SOME OTHER CABINET MEMBERS AND PARLIAMENTARY LEADERS.

2. FOREIGN EXCHANGE POLICY. BOI GOVERNOR BAFFI TOLD SECRETARY SIMON THAT BANK HAD HOPED THAT ITS FORCED WITHDRAWAL FROM EXCHANGE MARKET IN JANUARY WOULD PRESENT CHALLENGE TO POLITICIANS TO TAKE ACTION ON CRITICAL BUDGET DEFICIT AND WAGE COST PROBLEMS. THEY HAD LARGELY FAILED TO DO SO. THUS, ADVERSE REACTION OF MARKET WHEN BANK RE-ENTERED ON MARCH 1 WAS NOT SURPRISING. IN PART LARGE-SCALE INTERVENTION IN FIRST FEW DAYS REFLECTED PENT-UP DEMAND ACCUMULATED DURING CLOSURE OF OFFICIAL MARKET, PLUS SEASONAL FACTORS. INTERVENTION ON INITIAL SCALE WAS CLEARLY NOT SUSTAINABLE. EXCHANGE MARKET SEEMED NOW TO BELIEVE THAT 800 LIRE PER DOLLAR RATE WAS PERHAPS ADEQUATE, AT LEAST IN SHORT RUN. BOI CALCULATIONS SEEMED TO CONFIRM THAT THIS RATE SUFFICIENTLY COMPENSATED FOR RELATIVELY FASTER PRICE RISES IN ITALY THAN ABROAD. UNFORTUNATELY, SOME POLITICIANS VIEWED EXCHANGE RATE MOVEMENTS AS THERMOMETER WHICH MEASURED ADEQUACY OF GOVERNMENT'S ECONOMIC POLICY PERFORMANCE. BOI OFFICIALS RECOGNIZED BANK'S INABILITY TO INTERVENE HEAVILY BUT FEARED INFLATIONARY EFFECT OF DEPRECIATING LIRA. BAFFI URGED SECRETARY TO TRY TO PERSUADE GOI

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OFFICIALS OF NEED TO USE OTHER ECONOMIC POLICY TOOLS, I.E., MEASURES TO REDUCE BUDGET DEFICIT AND TO DECELERATE WAGE RATE INCREASES. SECRETARY EMPHASIZED NEED TO LET MARKET FORCES DETERMINE EQUILIBRIUM EXCHANGE RATE AND FACT THAT RATE MUST BE ADEQUATE NOT JUST TO ELIMINATE CURRENT ACCOUNT DEFICIT BUT ALSO TO RESTORE EQUILIBRIUM IN ITALY'S OVERALL BALANCE (I.E., INCLUDING CAPITAL ACCOUNT).

3. MONETARY POLICY. US SIDE RECOGNIZED EFFORTS ALREADY MADE IN MONETARY FIELD THROUGH RISE IN DISCOUNT RATE, INCREASE IN BANK RESERVE REQUIREMENTS, AND OTHER EFFORTS TO INCREASE SHORT-TERM RATES. ITALIAN OFFICIALS REPORTED STATUS OF THEIR NEGOTIATIONS WITH EC AND IMF ON CREDIT LIMITS. EC COMMISSION WAS PROPOSING TO ESTABLISH CEILING ON TOTAL DOMESTIC CREDIT EXPANSION TO 29,500 BILLION LIRE, CEILING ON CREDIT TO FINANCE CASH BUDGET DEFICIT OF 13,800 BILLION LIRE, AND SUB-CEILING ON CENTRAL BANK CREDIT TO TREASURY OF 5,700 BILLION LIRE. THIS CONSTITUTED REDUCTION (COMPARED WITH LATE 1975 AGREEMENT WITH EC) IN TOTAL DOMESTIC CEILING OF 1,500 BILLION LIRE, OF WHICH TWO-THIRDS WOULD BE TAKEN AWAY FROM CREDIT TO TREASURY. US SUGGESTED POSSIBLE INCREASES IN MEDIUM AND LONG-TERM INTEREST RATES TO ENCOURAGE SAVINGS. BOTH BANK OF ITALY AND TREASURY OFFICIALS WERE CONCERNED THAT HIGHER LONG-TERM RATES WOULD INHIBIT INVESTMENT, ALTHOUGH BOI RECOGNIZED THAT ITALY MIGHT HAVE NO CHOICE BUT TO ACCEPT SOME INCREASE IN THESE RATES. SECRETARY SIMON ARGUED THAT IMPROVEMENT IN INFLATIONARY EXPECTATIONS MIGHT PROVIDE GREATER INCENTIVE TO INVESTMENT THAN ARTIFICIALLY LOW LONG-TERM INTEREST RATES.

4. FISCAL POLICY. BOI OFFICIALS SHARED US CONCERN ABOUT LARGE BUDGET DEFICITS AS SOURCE OF INFLATIONARY PRESSURES. THEY TENDED TO PREFER REDUCTION IN EXPENDITURES TO INCREASE IN TAXES, ARGUING THAT THERE WAS CONSIDERABLE WASTE IN PUBLIC EXPENDITURES. TREASURY'S VENTRIGLIA, ON OTHER HAND, THOUGHT CUTS IN EXPENDITURES WERE APT TO HURT PUBLIC INVESTMENT SINCE EXPENDITURES FOR CURRENT OPERATIONS WERE RIGID. THE SECRETARY STRESSED THAT MONETIZING BUDGET DEFICIT MIGHT BE EASIER ROAD TO FOLLOW BUT THAT INFLATIONARY EFFECTS WOULD INEVITABLY OCCUR.

5. INCOMES POLICY. GOVERNOR BAFFI URGED SECRETARY TO PRESS GOI TO MAKE EFFORT TO LIMIT EXCESSIVE WAGE INCREASES. EVEN
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THOUGH THE GOVERNMENT CONTROLLED LARGE PART OF INDUSTRY, STATE FIRMS HAD BEEN THE FIRST TO CONCEDE TO WAGE DEMANDS. GOVERNMENT SHOULD SET GUIDELINES FOR CONTRACTUAL WAGE INCREASES AT ZERO, ALLOWING COST OF LIVING MECHANISM ALONE TO OFFSET PRICE RISES. GOI SHOULD ALSO IMPOSE WAGE LIMITS ON STATE-OWNED INDUSTRY. BAFFI THOUGHT THAT LABOR CONFEDERATION LEADERS WERE NOW OPEN TO PERSUASION ON NEED FOR DECLARATION IN WAGE RATE INCREASES AND MIGHT BE CONVINCED THAT PURELY NOMINAL WAGE

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INFO OCT-01 SS-14 ISO-00 NSC-05 NSCE-00 EB-03 TRSE-00

CIAE-00 SP-02 OMB-01 INR-05 PRS-01 /040 W

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INCREASES DO NOT HELP ITALIAN WORKERS. MINISTER COLOMBO SHOWED SECRETARY PUBLIC STATEMENT (WHICH HE SUBSEQUENTLY RELEASED) CRITICIZING WAGE SETTLEMENT BY STATE-OWNED PART OF CHEMICAL INDUSTRY. SETTLEMENT HAD BEEN MADE WITHOUT INFORMING OR OBTAINING APPROVAL EITHER OF MINISTER OF TREASURY OR OF MINISTER OF STATE HOLDINGS. PRIME MINISTER MORO, TOO, THOUGHT THAT THERE WAS GREATER UNDERSTANDING OF WAGE RATE PROBLEM AT TOP LEVEL OF LABOR CONFEDERATIONS. HOWEVER, AT GRASS ROOTS THERE WAS MUCH LESS UNDERSTANDING AND WILLINGNESS TO MAKE SACRIFICES.

6. GROWTH FORECASTS. DURING LONG MEETING AT TREASURY MARCH 8, ITALIANS PRESENTED THREE ECONOMIC PROJECTIONS CONCERNING GROWTH, PRICES, AND BALANCE OF PAYMENTS IN 1976. FIRST CONSISTED OF ESTIMATES MADE LATE IN 1975 IN CONNECTION WITH TALKS WITH EC ON CONDITIONS ATTACHED TO OLD EC MEDIUM-TERM CREDIT. SECOND TOOK INTO ACCOUNT EFFECT OF DEPRECIATION OF LIRA SINCE JANUARY. THIRD ASSUMED BOTH LIRA DEPRECIATION AND PROBABLE REDUCTION IN CREDIT EXPANSION CEILINGS. ORIGINAL ESTIMATE CALLED FOR REAL GROWTH OF 2.4 PERCENT, PRICE RISE OF 12.4 PERCENT, INCREASE IN INVESTMENT OF 0.7 PERCENT, AND CURRENT ACCOUNT DEFICIT OF BALANCE OF PAYMENTS OF \$1 BILLION. SECOND FORECAST INVOLVING ONLY LIRA DEPRECIATION BUT ASSUMING THAT CURRENT ACCOUNT DEFICIT WOULD HAVE TO BE LIMITED TO ORIGINAL BILLION FIGURE RESULTED IN REAL GROWTH OF ONLY 1.7 PERCENT, CONFIDENTIAL

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16 PERCENT PRICE RISE AND DECLINE IN FIXED INVESTMENT OF 3 PERCENT. THIRD PROJECTION SUGGESTED THAT TIGHTER CREDIT LIMITS WOULD FURTHER REDUCE GROWTH IN GDP TO ONLY 1.2 PERCENT, WITH FIXED INVESTMENT DOWN 5 PERCENT BUT CURRENT-ACCOUNT DEFICIT ALSO REDUCED TO \$500 MILLION.

7. MINISTER COLOMBO ARGUED THAT, WHILE GOI WAS DETERMINED TO FOLLOW CORRECT LONG-TERM ECONOMIC POLICIES TO DEAL WITH UNDERLYING PROBLEMS, IT WAS NECESSARY TO ACHIEVE AT LEAST SOME POSITIVE GROWTH IN 1976. THIRD ALTERNATIVE WHICH REPRESENTED VERY MINIMUM GROWTH LEVEL AND DECLINE IN FIXED INVESTMENT OF 5 PERCENT, AFTER INVESTMENT HAD ALREADY DECLINED BY 12 PERCENT IN 1975, WAS WORRISOME. ON OTHER HAND, GOVERNOR BAFFI WAS SOMEWHAT CRITICAL OF "PURE KEYNESIAN" APPROACH TAKEN BY SOME GOVERNMENT ADVISERS, AND SECRETARY SIMON ARGUED THAT MACROECONOMIC APPROACH AND SPECIFIC ECONOMETRIC PROJECTIONS HAD NOT PROVED RELIABLE. MORE ATTENTION SHOULD BE GIVEN TO SPECIFIC POLICY PROBLEMS, PARTICULARLY TO MEASURES WHICH IMPROVE WORLD INFLATIONARY EXPECTATIONS. THIS COULD HAVE IMPORTANT EFFECT IN REVIVAL OF INVESTMENT. MINISTER COLOMBO AGREED SOME COMMON SENSE APPROACHES WERE CALLED FOR, BUT THESE NEEDED TO BE BOLSTERED OR AT LEAST DISGUISED BY STATISTICAL PROJECTIONS.

8. BALANCE OF PAYMENTS. MINISTER COLOMBO, IN PARTICULAR, REPEATEDLY STRESSED BURDEN ON ITALIAN BALANCE OF PAYMENTS OF INCREASE IN OIL PRICES. HE POINTED OUT THAT OUTSTANDING COMPENSATORY BORROWING OF \$13.5 BILLION WAS EQUAL TO THREE YEARS OF INCREASED OIL DEFICIT. SECRETARY SIMON RECOGNIZED ADDITIONAL BURDEN IMPOSED ON ITALIAN BALANCE OF PAYMENTS BUT POINTED OUT THAT DEFICIT REPRESENTED ONLY ABOUT 3 PERCENT OF GDP AND THAT, EVENTUALLY, ADJUSTMENT WOULD HAVE TO BE MADE TO ABSORB THIS BURDEN. DR. OSSOLA WAS CONCERNED ABOUT VERY SMALL MARGIN FOR MANEUVER AVAILABLE TO BANK IN EXCHANGE MARKET BECAUSE OF LOW LEVEL OF RESERVES, WHICH NOW COVERED ONLY 15 DAYS OF IMPORTS, RATHER THAN TRADITIONAL TWO TO THREE MONTHS. IN ADDITION TO NEW IMF STANDBY OF \$530 MILLION, BUNDESBANK GOLD LOAN DRAWING OF \$500 MILLION, AND EC JOINT BORROWING OF \$1 BILLION (WHICH WOULD HAVE TO BE USED TO REPAY FRB \$750 MILLION SWAP DRAWINGS); OSSOLA MENTIONED TWO ADDITIONAL SOURCES OF FINANCING AS RATHER HYPOTHETICAL, I.E., BORROWING RESID-

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UAL AMOUNT STILL AVAILABLE TO EC MEMBERS UNDER MEDIUM-TERM CREDIT ARRANGEMENTS (ABOUT \$550 MILLION) AND BORROWING FROM OECD FINANCIAL SUPPORT FUND (ITALIAN QUOTA OF ABOUT \$1.6 BILLION). OSSOLA THOUGHT THAT EC COULD NOT ALLOW A SINGLE MEMBER COUNTRY TO COMPLETELY EXHAUST MEDIUM-TERM FACILITY AND SEEMED SKEPTICAL ABOUT UTILIZATION OF OECD CREDIT. (SUBSEQUENTLY, DR. PALUMBO ASSURED TREASURY ATTACHE THAT GOI VIEW ON UTILITY

OF FINANCIAL SUPPORT FUND WAS, IN FACT, VERY FAVORABLE.) REGARDING DANGER TO BALANCE OF PAYMENTS IN COMING WEEKS AND MONTHS DUE TO CAPITAL FLIGHT, BOI OFFICIALS ASSURED SECRETARY THAT BANK WOULD TRY TO KEEP BETTER CONTROL OVER LIQUIDITY. HOWEVER, EVEN RELATIVELY MODEST REVIVAL OF CAPITAL OUTFLOW COULD GET BANK INTO TROUBLE. OSSOLA FEARED THAT LETTING EXCHANGE RATE TAKE FULL BURDEN OF PRESSURE WOULD LEAD TO WAGE PRICE SPIRAL BECAUSE OF WIDESPREAD INDEXING OF WAGES. MINISTER COLOMBO HOPED THAT IN EVENT OF ANY NEW RUN ON LIRA, SOME HELP WOULD BE FORTHCOMING FROM ITALY'S FRIENDS. SECRETARY SIMON STRESSED WITH PRIME MINISTER MORO AND OTHERS THAT, UNLESS BASIC ECONOMIC PROBLEMS WERE DEALT WITH, NEW FOREIGN CREDITS WOULD SIMPLY BE MONEY DOWN THE DRAIN.

9. POLITICAL CONSIDERATIONS. PRIME MINISTER MORO, TREASURY MINISTER COLOMBO, GOVERNOR BAFFI AND INDEED ALL GOVERNMENT LEADERS WHOM SECRETARY MET DURING HIS VISIT TENDED TO STRESS POLITICAL PROBLEMS ASSOCIATED WITH TAKING UNPOPULAR ECONOMIC MEASURES. BAFFI ATTRIBUTED POLICY OF REFLATION IN LAST HALF OF 1975, IN PART, TO PRESSURES FROM POLITICIANS TO GET ECONOMY MOVING AGAIN BEFORE ELECTIONS WERE HELD. IT APPEARED THAT FAILURE OF GOI TO MAKE USE OF TIME WHEN BOI WAS OUT OF THE EXCHANGE MARKET TO ADOPT ECONOMIC MEASURES REFLECTED FEARS OF POLITICAL CONSEQUENCES MORE THAN DIFFERENCES OF OPINION AS TO WHAT SHOULD BE DONE. SECRETARY SIMON AND OTHERS ON US SIDE SYMPATHIZED WITH ITALY'S DIFFICULT POLITICAL SITUATION BUT STRONGLY ARGUED THAT MINORITY GOVERNMENT HAD LITTLE TO LOSE FROM TAKING COURAGEOUS ACTION TO BEGIN TO RESOLVE BASIC PROBLEMS. THEY ARGUED THAT, IF THE NEED FOR THESE ACTIONS WERE PROPERLY EXPLAINED, ITALIAN PEOPLE WOULD RALLY ROUND GOVERNMENT AND US AND OTHER POTENTIAL FOREIGN CREDITORS WOULD FIND IT EASIER TO JUSTIFY ANY FINANCIAL ASSISTANCE WHICH MIGHT BE MADE AVAILABLE. IN SHORT, "GOOD ECONOMICS ARE ALSO GOOD POLITICS."

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10. COMMENT. THERE WAS CONSIDERABLE IDENTITY OF VIEWS BETWEEN US AND ITALIAN SIDES ON PROPER POLICIES TO DEAL WITH ITALY'S ECONOMIC ILLS. ITALIAN LEADERS PROFESSED WILLINGNESS TO TAKE DIFFICULT ECONOMIC POLICY DECISIONS BUT WERE CLEARLY NERVOUS ABOUT POLITICAL CONSEQUENCES OF ATTEMPTING TO ARREST RAPID WAGE RATE INCREASES AND RAISE TAXES OR CUT BUDGET EXPENDITURES. THEY ALSO WISHED TO BE REASSURED THAT, IF THEY TOOK SUCH MEASURES, SOME FOREIGN FINANCING WOULD BE AVAILABLE IN INTERIM PERIOD BEFORE MEASURES COULD PRODUCE RESULTS, SO THAT ITALY WOULD AT LEAST BE ABLE TO HAVE VERY MODEST REAL GROWTH IN 1976. ITALIANS DID NOT ASK FOR ADDITIONAL FOREIGN FINANCING AT THIS STAGE BUT WERE VERY CONSCIOUS OF POSSIBLE NEED FOR NEW FOREIGN CREDITS OVER NEXT YEAR OR TWO AND PERHAPS LONGER

TO COVER ANY CURRENT ACCOUNT DEFICIT AND TO MEET FOREIGN DEBT REPAYMENTS ON SCHEDULE. (AFTER SECRETARY'S DEPARTURE TREASURY DIRECTOR GENERAL PALUMBO TOLD TREASATT THAT HE BELIEVED IT ESPECIALLY IMPORTANT THAT PRIVATE EUROMARKET CREDITS BE PAID AS THEY FALL DUE, SO AS TO REESTABLISH ITALY'S CREDITWORTHINESS IN PRIVATE CAPITAL MARKETS.)

12. SECRETARY SIMON AND OTHER MEMBERS OF US DELEGATION ATTEMPTED TO ASSURE ITALIANS OF US SYMPATHY BASED ON POLITICAL, ECONOMIC, MILITARY AND SENTIMENTAL CONSIDERATIONS. NONETHELESS, US SIDE ARGUED STRONGLY THAT WITHOUT ADOPTION OF POLICIES TO DEAL WITH FUNDAMENTAL PROBLEMS, NEW FOREIGN FINANCING FROM ABROAD WOULD SIMPLY BE WASTED. THEY BELIEVED THAT COURAGEOUS ACTION BY DC GOVERNMENT TO DEAL WITH OBVIOUSLY SERIOUS ECONOMIC PROBLEMS, CALLING FOR SACRIFICES FOR ITALIAN PEOPLE, NEED NOT HURT POLITICAL IMAGE OF PARTY IN POWER OR OF OTHER DEMOCRATIC PARTIES, BUT MIGHT EVEN IMPROVE THEIR ELECTORAL CHANCES. VOLPE

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Message Attributes

Automatic Decaptioning: Z
Capture Date: 01 JAN 1994
Channel Indicators: n/a
Current Classification: UNCLASSIFIED
Concepts: ECONOMIC RECOVERY, FOREIGN RELATIONS, MEETING REPORTS, DIPLOMATIC DISCUSSIONS, POLITICAL SITUATION, MINISTERIAL VISITS
Control Number: n/a
Copy: SINGLE
Draft Date: 11 MAR 1976
Decaption Date: 28 MAY 2004
Decaption Note: 25 YEAR REVIEW
Disposition Action: RELEASED
Disposition Approved on Date:
Disposition Authority: vogelfj
Disposition Case Number: n/a
Disposition Comment: 25 YEAR REVIEW
Disposition Date: 28 MAY 2004
Disposition Event:
Disposition History: n/a
Disposition Reason:
Disposition Remarks:
Document Number: 1976ROME04037
Document Source: CORE
Document Unique ID: 00
Drafter: n/a
Enclosure: n/a
Executive Order: GS
Errors: N/A
Film Number: D760093-0073
From: ROME
Handling Restrictions: n/a
Image Path:
ISecure: 1
Legacy Key: link1976/newtext/t19760371/aaaackkh.tel
Line Count: 350
Locator: TEXT ON-LINE, ON MICROFILM
Office: ACTION EUR
Original Classification: CONFIDENTIAL
Original Handling Restrictions: LIMDIS
Original Previous Classification: n/a
Original Previous Handling Restrictions: n/a
Page Count: 7
Previous Channel Indicators: n/a
Previous Classification: CONFIDENTIAL
Previous Handling Restrictions: LIMDIS
Reference: n/a
Review Action: RELEASED, APPROVED
Review Authority: vogelfj
Review Comment: n/a
Review Content Flags:
Review Date: 30 APR 2004
Review Event:
Review Exemptions: n/a
Review History: RELEASED <30 APR 2004 by ElyME>; APPROVED <27 AUG 2004 by vogelfj>
Review Markings:

Margaret P. Grafeld
Declassified/Released
US Department of State
EO Systematic Review
04 MAY 2006

Review Media Identifier:
Review Referrals: n/a
Review Release Date: n/a
Review Release Event: n/a
Review Transfer Date:
Review Withdrawn Fields: n/a
Secure: OPEN
Status: NATIVE
Subject: RESULTS OF SECRETARY SIMON VISIT TO ROME SUMMARY. SECRETARY OF THE TREASURY SIMON VISITED ROME MARCH
TAGS: OVIP, EFIN, IT, US, (MORO, ALDO), (SIMON, WILLIAM), (COLOMBO), (BAFFI)
To: STATE
Type: TE
Markings: Margaret P. Grafeld Declassified/Released US Department of State EO Systematic Review 04 MAY 2006